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Chasing the Rogue Professional after the Private Securities Litigation Reform Act of 1995

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CHASING THE ROGUE PROFESSIONAL AFTER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

*Douglas M. Branson**

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In financial circles, rogues abound. Rogues include not only promoters and sellers of securities but, with some frequency, bankers, attorneys, accountants, investment bankers, appraisers, business consultants, tax consultants, financial planners, celebrity spokespersons, and others who assist promoters of various (and nefarious) schemes. Gullible citizens lose hundreds of millions of dollars each year in fraudulent pie-in-the-sky deals. Since enterprises in which investors have contributed funds often become judgment proof, investors seek to recover their funds from any rogues involved on the periphery, more euphemistically termed the "collateral participants" in a securities transaction.¹

The capstone of investor protections *ex ante*, and of means of investor recovery *ex post*, has always been the federal securities laws, most specifically the Securities Act of 1933² and the Securities Exchange Act of 1934.³ In individual and class actions, investors have been able to recoup significant portions of their losses, most frequently under the aegis of the federal securities laws.

During the early 1990s, a shorter term phenomenon was overlaid on all of this. In an era reminiscent of the old "strike suit" days, many newly public companies, particularly high tech companies, were being sued by class action lawyers resident in a few cities around the country.⁴ In "stock

1. See, e.g., Douglas M. Branson, *Collateral Participant Liability Under the Securities Laws—Charting the Proper Course*, 65 OR. L. REV. 327, 329-30 (1986) (collateral participant defined); Douglas M. Branson, *Collateral Participant Liability Under State Securities Laws*, 19 PEPP. L. REV. 1027, 1027 (1992) (collateral participant defined).

2. 15 U.S.C. § 77a-aa (1994).

3. 15 U.S.C. § 78a-ll (1994).

4. See, e.g., Andrew E. Serwer, *What to Do About Legal Blackmail*, FORTUNE, Nov. 1993, at 136 (profiling law firms Milberg, Weiss, Bershad, Hynes & Lerach and Chimicles, Burt & Jacobsen); Jill Abramson & Amy Stevens, *Class-Action Clash: King of 'Strike Suits' Finds Style Cramped by Legal Overhaul Bill*, WALL. ST. J., Mar. 30, 1995, at A1 (Milberg, Weiss represents plaintiffs in approximately one quarter of federal securities class cases pending). Cf. Richard Buck, *Taking Class Action—Attorney Fights Public Firms on Behalf of Shareholders*, SEATTLE TIMES, Dec. 19, 1994, at E1 (only law firm in Seattle doing plaintiffs stock drop suits has brought approximately eight to ten cases).

drop lawsuits," a decrease of fifteen percent or more in a corporation's share price brought forth a multiplicity of class action lawsuits filed within hours or days after the fall in price.⁵

"Big Six" accounting firms and other professional firms were also plagued by this phenomenon. They, too, were named as defendants in stock drop lawsuits, based upon their roles as collateral participants in securities offerings that later were alleged to have gone awry.⁶

These core groups—accountants, high tech firms, and the professionals who represent them—lobbied for "reform" and found responsive legislators in the politicians who were acutely aware of the United States's declining global competitiveness. Over a presidential veto,⁷ Congress enacted The Private Securities Litigation Reform Act of 1995,⁸ a permanent solution to the temporary phenomenon of the stock drop lawsuit. In doing so, Congress may adequately have addressed the temporary "stock drop lawsuit" problem, but it also severely undercut the ability of "private attorneys general" to address the permanent problem: the presence of rogues and the ubiquity of fraud whenever and wherever other people's money is being sought.

To compound the matter, federal courts had already begun addressing many of the excesses that had come to infect securities litigation. Both the United States Supreme Court and the lower federal courts had put in place a number of gatekeeping devices that enable defense attorneys to dismantle groundless, and some meritorious, suits under the securities laws.⁹

In another article, I have described the gauntlet a federal securities law plaintiff must now run due to the combined efforts of Congress and the

Similarly, in the 1980s, "reforms" for the law relating to derivative actions were driven solely by events at the *Fortune* 500 level companies and in New York and Washington, D.C., while, in the remainder of the country, it could be postulated that a completely different set of conditions prevailed in corporate litigation. See Douglas M. Branson, *The American Law Institute Principles of Corporate Governance and the Derivative Action: A View from the Other Side*, 43 WASH. & LEE L. REV. 399, 400 (1986) ("all corporate litigation does not involve a Harry Lewis and originate in the Wilmington-Philadelphia axis").

5. Compare Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority"*, 108 HARV. L. REV. 438, 443 (1994) (recounting congressional testimony that a 10% drop will result in lawsuits) with Baruch Lev, *Disclosure and Litigation*, 37 CAL. MGMT. J. 7, 8-9 (1995) (selecting 20% drop as relevant figure for statistical analysis of suits).

6. The coalition lobbying for the legislation amassed an early \$12 million war chest, mostly from the accounting profession. See Dodd, *Domenici Introduce Securities Litigation Reform Measure*, 26 SEC. REG. & L. REP. (BNA) 440 (Mar. 25, 1994).

7. See Clinton Vetoes Sweeping Reform Bill, 27 SEC. REG. & L. REP. (BNA) 1955 (Dec. 22, 1995).

8. Pub. L. No. 104-67, 109 Stat. 737 (1995) [hereinafter Reform Act].

9. See, e.g., The Fourth Annual Fritz B. Burns Lecture, Central Bank: *The Methodology, the Message and the Future*, 29 LOY. L.A. L. REV. 1 (1995); Donald C. Langevoort, *Disclosures That "Bespeak Caution,"* 49 BUS. LAW. 481 (1994); Margaret V. Sachs, *Freedom of Contract: The Trojan Horse of Rule 10b-5*, 51 WASH. & LEE L. REV. 879 (1994).

federal courts.¹⁰ I will not replicate that effort, which proved to be daunting. The question this Article asks is rather, after "reform, what is left?" A subsidiary goal is to support the proposition that rogues do exist, remain plentiful, often wear the cloak of the professional, and are, more than ever, difficult to bring to ground.

Thus, Part I of this Article includes some vignettes of cases in which I participated as a consultant. These cases all involve rogue professionals and are drawn exclusively from a distant and non-commercial corner of the United States, the Pacific Northwest. Part I ends with a collection of third person reports from around the country of other depredations committed by professionals in securities transactions.¹¹ After setting forth that evidence in support of the proposition that indeed "rogues abound," Part II then describes and analyzes some alternatives to class litigation under the federal securities acts, means possibly to evade the numerous obstacles recently placed astride the path to the federal courthouse.

I. TALES OF ROGUERY: A BUTCHER, A BAKER, AND A CANDLESTICK MAKER

A. A ROGUE LAWYER

1. *A Lesson in Elementary Economics: Apples and Offerings*

Those experienced in the ways of commodities businesses, or those familiar with economic theory, are wary of upward trending prices for the commodity. They know that, as prices rise to new peaks, valleys are certain to be encountered in the future. The reason is that higher prices bring on stream marginal capacity. Once the marginal product begins to reach markets, supply will exceed demand. Inevitably, a trough or valley lies ahead.¹²

In the late 1970s, in Washington State, apple prices were rising steadily toward new all-time highs. Orchardists were wary, but two accountants and an engineer from Seattle were not. The trio conceived an idea of purchasing apple orchards in order to syndicate them to investors around the region and perhaps other areas of the United States. The three promoters usually would agree to pay the orchard owner his asking price, or close thereto, which also would be at an historically high level, in return for two quid pro quo. The conditions were that, first, there would be little

10. See Douglas M. Branson, *Running the Gauntlet: A Description of the Arduous (and Now Often Fatal) Journey for Plaintiffs in Federal Securities Law Actions*, U. CIN. L. REV. (1996) (forthcoming) (on file with the author).

11. Apologies to the vast majority of professionals whose hard work and high level of honesty and integrity is unquestioned. However that may be, Oliver Wendell Holmes cautioned us that when one approaches the law, and law reform proposals, one "must look at it as a bad man, who cares only for the material consequences . . . knowledge enables him to predict" and "not as a good one, who finds his reasons for conduct . . . in the vaguer sanctions of conscience." OLIVER W. HOLMES, *The Path of the Law*, in COLLECTED LEGAL PAPERS 171 (1920).

12. See, e.g., RICHARD G. LIPSEY & PETER O. STEINER, *ECONOMICS* 242-43 (3d ed. 1972). The analysis assumes that barriers to entry, if any, are not significant.

or no down payment, and, second, closing would be a number of months following acceptance of the offer to purchase.

In turn, the temporal space from offer to closing was necessary for two reasons: first, to subdivide the orchards into 12, 15, or 20 parcels¹³ and, second, to prepare private placement disclosure documents for and to syndicate 12, 15, or 20 general partnership offerings of 6 to 8 units each per orchard property.

Necessarily, the process entailed great quantities of legal work. That was especially true when the promoters' business plan involved purchase and syndication of three or four orchards per year at an aggregate price of \$1.5 million or so per orchard. Plats of subdivision had to be prepared and walked through governmental agencies in remote counties of the state. Partnership agreements and management contracts had to be drafted. Last of all, state and federal securities law compliance had to be assured.

2. *Enter the Rogue Lawyer*

The promoter accountants were cost conscious when it came to disbursing money for professional services. They solicited bids for rendition of professional services. The rogue lawyer was the low bidder because he agreed to teach the promoters how to do the securities work "in house" in return for a promise that his firm would receive all the remaining legal work generated by the acquisition and syndication process.

With agreement struck, the lawyer prepared the initial private placement memorandum, made the necessary filings with the state securities division, and ensured compliance with SEC Regulation D. He did no due diligence, accepting, for example, at face value the promoters' projections that apple prices would continue to rise and that, under their stewardship, the quantity produced would increase as well. The double barrelled effect of rising prices and quantity assured investors that, beyond the initial payment by investors, the cash flow from the orchard would cover all the payments to creditors, including the retired orchardist holding a real estate contract. The projections actually showed investors receiving distributions from a positive, and then a cascading, cash flow in years three, four, and beyond.

On the second orchard offering, a promoter cut and pasted documents from the first offering. The rogue lawyer then red lined that product, later meeting with the client several times to teach him how to do the securities work in house. On subsequent offerings, the promoters merely copied the rogue lawyer on the offering document, filing the document if they heard no comment from him.

At that point, nothing may have reached an objectionable stage. The securities lawyer generally quarterbacks the due diligence effort, but it is

13. Cf. SEC v. W. J. Howey Co., 328 U.S. 293 (1946) (subdivision of orange groves into rows for sale to individuals rather than to partnerships).

the client's ultimate responsibility. Many securities lawyers have been beseeched by clients who are repeat syndicators to let them do some or all of the securities work. As a self-preservation matter, most lawyers agree it would be foolish for a securities lawyer to accede to such a client request. Yet nothing prohibits a securities lawyer and a repeat syndicator from "job sharing" securities work.

But, in the case *sub justice*, after a handful of offerings, the state securities regulators began asking a few routine questions.¹⁴ Immediately upon receiving the written inquiry, the promoters forwarded the letter to the rogue lawyer. The lawyer would then reply, writing to the regulator under the letterhead of his well-regarded law firm. "This office represents these promoters in connection with the Chief Joseph Orchard," he would write. Literally, the statement was true. But in context the statement was intended to put the state regulator off the scent. The tactic worked. The regulator undoubtedly assumed that a reputable law firm was involved and was doing the securities work, and hence, his inquiry should be reassigned as a lower priority.

The syndications were a great success. School teachers, police officers, railroad conductors, truck drivers, and many other ordinary persons bought the securities. What could be more American, more solid, than a \$25,000 investment in a Washington State apple orchard, especially with the promise of Japanese and other world markets ever opening to the product? The promoters syndicated approximately eighteen orchards over four years, raised over \$25 million, and, over and above the 12%-14% syndication fees, enjoyed management fee income of \$350,000 each per year.

3. *The Beginning of the End*

Accountants are usually not pomologists, though. Therefore, the promoters had to pay additional fees to hire managers who actually knew something about apple orchards. In turn, those managers did not relish dirtying their hands. They installed yet another layer of managers who would live on the properties. Those on-site managers would then hire workers to prune, fertilize, and harvest. What had been a roller coaster commodities business, in down times barely able to support the orchardist who did much of the work himself, now had three or four layers of new "management" that the promoters had installed. Then, as could have been predicted, prices fell. The double barrel effect worked in reverse: prices fell, and, due to inept management, quantity of output decreased as well.

14. The regulator inquired whether or not the multiple offerings were part of a single overall plan of financing. The question, then, called for the issuer, or its attorney, to show cause why the offerings, otherwise exempt, should not be "integrated." See, e.g., Preliminary Note 6 to SEC Regulation D, 17 C.F.R. § 230.501 (1996) ("[R]egulation D is not available to any issuer for any transaction or chain of transactions that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the Act."). State regulators apply the same standard as the SEC does.

Out went the call to partners for additional cash contributions. Because the entities were general partnerships, investors were liable for the debts of the partnership. On a \$25,000 investment, many investors paid an additional \$35,000 to \$40,000 before they said "no more" and consulted counsel.

The rogue lawyer assisted in oiling any squeaky wheels. He proposed and prepared documents for a "roll up" partnership whose business plan stated that its purpose was to purchase interests in "various orchard properties" in the Pacific Northwest. Left unstated was precisely whose interests those would be. They would be the interests of any prior investor who had complained and who had also gone to the trouble of retaining counsel. The roll up entity allowed the "squeaky wheel" investor to be paid back nearly all of her investment. In that way, the end of the scheme was prolonged for an additional year or more.

Then the orchard venture screamed to a halt. Investors stopped paying additional contributions. They began to network, eventually banding together to hire litigation counsel. Meanwhile, the rogue lawyer traveled to Holiday Inn meetings in cities in which investors lived, aiding in the harangue designed to provoke payment of further assessments.

The retired orchardists foreclosed on the properties. Two promoters declared bankruptcy; the third absconded with funds. The investors brought an action in the federal district court for the Eastern District of Washington against the rogue lawyer, two banks who had aided in keeping the scheme afloat, and the accountants who had "compiled" the projections.¹⁵

The lawyer was a rogue. He turned a blind eye toward disclosures he knew to be reckless or, in the exercise of a minimum of care, would have known to be false. He actively assisted in creating a false impression in regulators' minds that a reputable law firm had done the securities work in the various offerings.¹⁶ In return, for doing the "other" legal work, his law firm received \$400,000 or so in fees over four years. In the securities work he did do, he did not perform up to what should be "the minimum engagement," which is to help the client comply with an exemption. It is not, and cannot be considered to be, merely the scrivener of a disclosure document with pie-in-the-sky projections.

15. *Anderson v. Thompson*, 144 F.R.D. 393 (E.D. Wash. 1992).

16. See, e.g., Branson, *Collateral Participant Liability Under State Securities Laws*, *supra* note 1, at 1036-37 (footnotes omitted):

The attorney who because of ignorance of securities law, or perhaps more likely a desire to get or retain the client's other legal business, turns a blind eye to a registration or a disclosure violation, is as culpable as one who over-performs. An appraiser who gives a high appraisal based upon incomplete analysis and labels it "for client's eyes only," knowing full well that the document will be a keystone in selling a deal, under-performs but seems culpable. The accountant who prepares track record data for a repeat syndicator or an investment advisor, knowing it to be puffed considerably, but labels it a "compilation," under-performs . . . but may be as culpable as the primary defendant.

4. *Commencement of Litigation*

Yet it was difficult to bring the rogue to ground. The judge dismissed fifteen or so counts, holding that general partnership interests are not securities.¹⁷ He declined to exercise pendant jurisdiction over state law claims such as breach of fiduciary duty, aiding and abetting breach of fiduciary duty, and violations of state securities laws.

After protracted discovery, the case went to trial only as a RICO conspiracy case. The predicate acts were fraud violations in the three syndications that took the corporate form. The attorney was alleged to have participated in and aided and abetted the fraud violations. After a four month trial, the jury returned a RICO conspiracy verdict but found the conspiracy to have been formed only very late in the game, around 1983, rather than 1980. As a result, the verdict, \$1.6 million plus attorneys' fees, was small in comparison to investors' losses.

The plaintiffs' attorneys refiled the pendant claims in state court in Montana. They commenced additional discovery. The case proceeded to a few months shy of trial when a settlement returned to investors most of their investment but without the 7, 8, or 9 years of interest they had foregone.

5. *The Safe Harbor for Projections of Future Economic Performance and the Bespeaks Caution Doctrine*

The case was difficult, but under the Private Securities Litigation Reform Act (the "Act") and recent judicial developments, the case would have been impossible. The misleading projections would not be actionable. The rogue lawyer knew enough to plaster his disclosure documents with disclaimers and cautionary language ("there can be no assurance that a, b, c, d, e, etc. will occur" or "that the sun will ever shine again" or "that rain will ever fall in the Pacific Northwest"). The Act provides that with respect to public companies and initial public offerings, if disclosures have appended to them sufficient cautionary language,¹⁸ the judge must grant any dispositive motion presented as to those misleading disclosures or omissions.¹⁹ In exempt offerings, the same result is now reached by means of the judicially evolved "bespeaks caution" doctrine.²⁰

17. *Matek v. Murat*, 862 F.2d 720, 728-30 (9th Cir. 1988) (standard general partnership interests are not securities). The Ninth Circuit later reversed itself. See *Koch v. Hankins*, 928 F.2d 1471, 1478 (9th Cir. 1991) (applying the principles of *Hocking v. DuBois*, 885 F.2d 1449, 1457, 1460 (9th Cir. 1989), *cert. denied*, 494 U.S. 1078 (1990)). Other circuits as well had found standard general partnership interests not to be securities. See, e.g., *Banghart v. Hollywood Gen. Partnership*, 902 F.2d 805, 808 (10th Cir. 1990) (movie production partnerships); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 240-42 (4th Cir. 1988) (fishing boats partnership).

18. Reform Act, *supra* note 8, § 102(a) (forward-looking statements "accompanied by meaningful cautionary statements").

19. *Id.* (no discovery is permitted and the federal judge must dismiss).

20. See generally Royce de R. Barondes, *The Bespeaks Caution Doctrine: Revisiting the Application of Federal Securities Law to Opinions and Estimates*, 19 J. CORP. L. 244 (1994); Langevoort, *supra* note 9.

6. *Elimination of Securities Fraud as a Predicate Act Under RICO*

It has always been curious that securities law registration violations are not predicate acts for RICO. A civil RICO claim, of course, raises the prospect of treble damages and an award of attorney's fees to the prevailing plaintiff.²¹

Securities lawyers generally regard registration violations as the more serious sin, in part because Section 12(1) of the Securities Act provides for strict liability in that case.²² In egregious disclosure cases, courts have held that delivery of a materially misleading prospectus fails to satisfy the Act's prospectus delivery requirements.²³ In that way, attorneys have attempted to bootstrap antifraud rule violations into registration violations.

Under RICO, however, the objective is the reverse. Misleading disclosures and failures to disclose have been the raw material with which a plaintiff can allege predicate acts of securities fraud.²⁴ One allegation is that a registration violation renders the entire offering subject to rescission. Hence, the financial statements should disclose a contingent liability. They never do. So, in that manner, lawyers have attempted to convert a registration violation into a disclosure or antifraud violation.

Under the new "reform" Act, however, securities fraud has been eliminated as a predicate act for establishing a RICO treble damage claim.²⁵ Federal RICO will no longer be a significant factor, or a factor at all, in securities litigation.

7. *The Demise of Aiding and Abetting Liability*

As has been mentioned as an argument that "reform" legislation was not needed, the Supreme Court has been steadily at work. The justices' work product also would have made prosecution of the case against the rogue lawyer more difficult.

Despite twenty-five years of court holdings that collateral participants could be liable for aiding and abetting primary violators' violations of the securities laws, the Court in *Central Bank v. First Interstate Bank*²⁶ ended aiding and abetting liability. *Central Bank* also casts grave doubt about other forms of implied secondary liability utilized in attempts to hold lia-

21. See 18 U.S.C. § 1964(c) (1994) ("recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee").

22. Securities Act of 1933 § 12(1), 15 U.S.C. § 7711 (1994).

23. See, e.g., SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1094-96 (2d Cir. 1972).

24. See 18 U.S.C. § 1961(1)(D) (1994) (listing only "fraud in the sale of securities" among the requisite predicate acts).

25. See Reform Act, *supra* note 8, § 107, amending 18 U.S.C. § 1964(c) ("no person may rely upon any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of section 1962").

26. 114 S. Ct. 1439, 1455 (1994). The Court majority ignored its own legislative reenactment doctrine under which later comprehensive examination and amendments of the securities laws would constitute congressional approval of judicial developments such as aiding and abetting. See *id.* (Stevens, J., dissenting).

ble collateral participants such as the rogue lawyer.²⁷ Thus, allegations of conspiracy or respondeat superior may not hold water.

In the case of the rogue attorney, at least toward the end, he also made direct statements to investors or participated in statements made by others. He may still then have been held liable under the federal securities laws, but the extent of such liability is unsettled.²⁸

8. *An End to Expanded Seller Status Under Securities Act Section 12(2)*

A few years before *Central Bank*, the Court also in large part eliminated another substantive basis for holding liable rogue professionals and other collateral participants. *Ernst & Ernst v. Hochfelder*²⁹ had held that in order to recover damages under the general antifraud rule, Rule 10b-5, a securities plaintiff had to prove more than a mere lack of reasonable care.³⁰ To skirt *Hochfelder* and its higher state of mind requirements, plaintiffs began to sue under Section 12(2) of the Securities Act of 1933, an antifraud provision which, through articulation of reasonable care as an affirmative defense, grounds liability on negligence.³¹

Under that section, plaintiffs often succeeded in holding collateral participants liable under "expanded seller" and "participation" concepts. In *Pinter v. Dahl*,³² the Court brought an end to "expanded seller" status. The Court limited Section 12 liability to sellers who actually pass title or to persons who actually solicit the purchase, motivated in part by a desire to serve their own financial interests or those of the securities owner. The Court further limited liability to sellers for gain, eliminating liability for one who from a surfeit of enthusiasm or perceived friendship makes misrepresentations in convincing another to invest. In that way, *Pinter* largely eliminated Section 12 as a tool for reaching great numbers of culpable collateral participants in securities transactions. A later Supreme

27. See, e.g., *Court Dismisses Conspiracy Claim, Citing High Court Central Bank Ruling*, 27 Sec. Reg. & L. Rep. (BNA) 1439 (Sept. 15, 1995); Marc I. Steinberg, *The Ramifications of Recent U.S. Supreme Court Decisions on Federal and State Securities Regulation*, 70 NOTRE DAME L. REV. 489, 501-02 (1995) (by parity of reasoning, *Central Bank* may also emasculate respondeat superior liability).

28. See *infra* part II.A.

29. 425 U.S. 185 (1976).

30. Subsequently, in *Aaron v. SEC*, 446 U.S. 680, 701 (1980), the Court held that in seeking injunctive relief, the SEC also had to prove intentional or knowing conduct on the defendant's part.

31. The section makes liable

[A]ny person who . . . offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact . . . and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security.

15 U.S.C. § 77l (1994).

32. 486 U.S. 622 (1988) (construing the companion registration violation liability provision, § 12(1)).

Court decision cuts back the section's efficacy still further.³³

Pinter, however, serves to illustrate what may be a widely held misunderstanding of professionals and their roles in securities transactions. In the apple orchard case, the rogue lawyer may have had some *Pinter* liability, for he did solicit additional capital contributions from investors. The fact but perhaps not the extent of the liability seems clear.

9. *A One-Sided and Deficient View of Rogue Professionals' Culpability*

Yet the rogue lawyer's greatest culpability seems to lie in his under performing in the case of the earlier offerings pursuant to registration exemptions under state and federal law, or his under performing while turning a blind eye toward wrongdoing by others.³⁴ The *Pinter* Court seems to harbor an intuitive feeling that lawyers and other professionals should be held liable only when they become overinvolved in the wrongdoing client's affairs—extremely overinvolved when one considers the requirements that they actually have solicited or sold securities.

The Court may be correct as a matter of statutory construction but is wrong as to the degree and kinds of culpability involved in securities transactions. The professional who knows about wrongdoing yet who continues to render assistance while turning a blind eye to violations of the securities laws is much more frequent and seems just as culpable as the one who, out of greed or enthusiasm, plays a role in the solicitation of investors. There is and should be a minimum that comes with the territory and that minimum should include at least a duty to withdraw when a lawyer becomes aware of wrongdoing. But *Pinter*, *Central Bank*, and the "bespeaks caution" doctrine seem to render immune from liability many professionals who under perform and whose culpability in so doing is a substantial factor in causing investors' losses.³⁵ The blind eye has been emblazoned on the shield wielded by the under-performing professional.

33. *Gustafson v. Alloyd Co., Inc.*, 115 S. Ct. 1061 (1995), then limited § 12(2)'s reach to public offerings of securities, negating its use for misrepresentations in aftermarket transactions or possibly in exempt issuer offering. *Gustafson* has been described as "the most poorly-reasoned, blatantly results-driven securities opinion in recent memory." Stephen M. Bainbridge, *Securities Act Section 12(2) After the Gustafson Debacle*, 50 Bus. Law. 1231, 1231-32 (1995).

34. In my analysis of fact patterns in state law securities cases, courts seem to find liability in cases in which, beyond rendition of routine professional services, lawyers or other collateral participants (1) turn a blind eye toward obvious wrongdoing by others or (2) actively assist the wrongdoer in creating a false impression that will mislead third parties such as investors or state and federal regulators. See Branson, *Collateral Participant Liability Under State Securities Laws*, *supra* note 1, at 1060 (analyzing Oregon cases).

35. Lower federal and state courts have a similar fix, holding, for example, that lawyers cannot be held liable if their involvement constitutes merely "daily grist for the mill," *Camp v. Dema*, 948 F.2d 455, 464 (8th Cir. 1991), or nothing more than "the usual drafting and filing services provided by counsel," *Hines v. Data Line Sys., Inc.*, 787 P.2d 8, 20 (Wash. 1990).

B. THE ROGUE ACCOUNTANT

Hanna International was a Portland, Oregon success story. The Hanna Enterprise ("Hanna") manufactured a line of brushless commercial car wash equipment that was ideally suited to today's high priced luxury automobiles and the preservation of their finishes. Hanna also sold a line of car wash products. Last of all, Hanna owned and operated a number of car washes in cities throughout the western United States. Through the 1970s and 1980s, the Hanna empire had recorded phenomenal growth.

To finance that growth, in the early 1980s Hanna offered \$30 million in medium term notes to Portland, Oregon area investors. Four offerings in four years were registered with state authorities, relying on the intrastate exemption from registration available under the federal Securities Act.³⁶

The offerings succeeded in the marketplace as well. Hanna promised, and paid for a time, rates of return one and one-half to two percentage points higher than rates available on any other investments. Even though the return sounded too good to be true, always a sign of a Ponzi scheme,³⁷ the offerings were fully subscribed.

In fact, the notes' terms were too good to be true. The proceeds of later note offerings were being utilized to pay the interest on early offerings and bank borrowings. For its last few years, the Hanna car wash empire was running on the fumes in its tank provided by the note offerings. Suddenly, the Hanna empire collapsed, entering bankruptcy.

In the subsequent class action suit brought on behalf of note holders, many of whom were retired on fixed incomes, class counsel made some amazing discoveries. The Hanna empire was not a unitary structure at all. Instead, it was a snake ball of over 100 entities, including partnerships, limited partnerships, corporations, and proprietorships. At the head of it all was Dan Hanna himself, operating the entire empire out of his hip pocket, as it were, as a sole proprietor.

In each of the four note offerings, Hanna had retained a "Big Six" accounting firm to audit the enterprise. Each of the offering documents included a "clean letter" from the accountants, opining that the financial statements had been prepared "in accordance with generally accepted accounting principles" and audited "in accordance with generally accepted auditing standards." Class counsel served a request for production of the

36. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1994).

37. A ubiquitous form of fraud named after Carlo Ponzi (1882-1949), an Italian immigrant who built a high interest rate loan scheme from \$200 to \$15 million by promising and paying 50% interest in 45 days and by paying his agents 10% commissions. See DONALD H. DUNN, *PONZI!: THE BOSTON SWINDLER* (1975).

Ponzi schemes' great failing is that the circle of victims must continuously widen, for new investors' capital is used to pay the high returns to those who invested previously. At some point, the swindler will not be able to find sufficient numbers of additional lenders or investors. It then becomes a matter of time before the bubble bursts. Nonetheless, various kinds of Ponzi schemes are among the most frequently encountered forms of securities fraud.

accountants' work papers. On one of the very first audits, the partner in charge at the accounting firm had scrawled in large letters on a work paper, "this client is unauditable." Yet several weeks later the firm issued the first of the several clean opinion letters previously mentioned.

It is difficult to term a Big Six national accounting firm a "rogue." However termed, though, after discovery of the partner's scrawl, the accounting firm became the principal target of the securities lawyers representing the class. Nowadays, though, it may be a wonder to progress that far because federal courts are giving renewed emphasis to the Federal Rule of Civil Procedure's mandate that "the circumstances constituting fraud or mistake shall be stated with particularity."³⁸

Conservative federal judges interpret the mandate as effectively requiring pleading of evidence. "This [the rule] means the who, what, when, where, and how: the first paragraph of any newspaper story."³⁹

In the Hanna car wash empire case, though, at least initially, the lawyers could not have pleaded the who, what, when, where, and how as to the accountants. Only after some discovery did the attorneys realize the tangle of corporations and partnerships that existed, something the accountants never did discover. The attorneys also discovered the imprudent notation on the work papers by the accountant in charge. At the beginning, all the lawyers could have alleged was the positive reported results and the accounts' clean opinion letter, followed by a complete financial collapse. Under the pleading fraud with particularity banner, federal courts have viewed such *res ipsa loquitur* approaches to pleading as "shoot for the moon" pleading. They have dismissed the complaint in such cases.⁴⁰

A corollary to pleading fraud with particularity is less liberality by federal courts on the subject of amendment of pleadings.⁴¹ A traditional approach has been to file a relatively skeletal complaint, fleshing out the allegations with several successive amended complaints as discovery enables the plaintiff to add details. When the evidence is particularly in the defendants' control, that may be the only possible approach. In securities cases today, however, the pleading fraud with particularity requirement militates against such an approach.⁴² In the Hanna car wash empire case, the plaintiffs' attorneys may not have been able to flesh out their case

38. FED. R. CIV. P. 9(b).

39. DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir.), *cert. denied*, 498 U.S. 941 (1990).

40. See *Romani v. Shearson Lehman Hutton*, 929 F.2d 875 (1st Cir. 1991). In *Romani*, the day after a large race horse breeding partnership had been syndicated, Shearson announced that a key player and general partner was leaving the enterprise. The plaintiff thus raised the inference that Shearson must have known of the impending departure but did not disclose it because disclosure would have impeded the sale of the partnership units. In the eyes of many federal judges, such "must have known" approaches do not comport with the requirement that fraud be pleaded with particularity.

41. Cf. FED. R. CIV. P. 15(a) (leave to amend "shall be freely given when justice so requires").

42. See, e.g., *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1175 (2d Cir. 1993) (opprobrium heaped upon plaintiffs' pleading because, with two amended complaints, he has still

against the accountants in time under the prevailing federal court approaches to pleading.

The Hanna case, however, did not arise as a federal court case. Oregon attorneys have long avoided federal court in securities cases, in part due to the gradually closing window in the federal arena but more so due to the liberality of Oregon state law. Thus, the case proceeded in the Circuit Court of Multnomah, Oregon under the style *Barlean v. Black*.⁴³

For many attorneys, state securities law has always been preferable from one standpoint. Most state securities laws provide that a prevailing plaintiff recovers her attorney's fees.⁴⁴ In addition, under a handful of state statutes, including Oregon, the plaintiff need not shoehorn the collateral participant into some notion of expanded seller status under a statute that renders liable certain named individuals and sellers.⁴⁵ Oregon holds liable "every person who participates or materially aids in the sale" that violates antifraud or registration provisions.⁴⁶

The provision was construed by Justice Hans Linde in *Prince v. Brydon*.⁴⁷ In *Prince*, an Idaho attorney had prepared documents, including an offering circular, for a mining investment. The attorney knew that one partner intended to sell units in Oregon but did not do any legal work on compliance with the Oregon Securities Act. Nonetheless, there was no evidence in the record that the attorney knew of active wrongdoing of the type found in federal aiding and abetting cases. Disagreeing with the Oregon Court of Appeals, Justice Linde held there need not be proof of knowledge of wrongdoing:

Whether one's assistance in the sale is "material" does not depend on one's knowledge of the facts that make it unlawful; it depends on the importance of one's personal contribution to the transaction. Typing, reproducing, and delivering sales documents may all be essential to a sale, but they could be performed by anyone; it is a drafter's knowledge, judgment, and assertions reflected in the contents of the documents that are "material" to the sale.⁴⁸

Thus, in Oregon, the dividing line has become not knowledge or a strong inference of knowledge of wrongdoing, but rather ministerial or scrivener's acts versus more substantial functions.

An Oregon defendant can exonerate herself by proof, that, in the exercise of reasonable care, she could not have known "of the existence of the

not linked alleged misleading statements with particular directors of the defendant corporation).

43. No. 9012-07865 (Cir. Ct. of Multnomah County, Or. 1990).

44. See, e.g., ALASKA STAT. § 45.55.930(a) (1994) ("reasonable attorneys' fees"); ARIZ. REV. STAT. ANN. § 44-2001A (1994 & Supp. 1995) ("taxable court costs and reasonable attorneys' fees"); TEX. REV. CIV. STAT. ANN. art. 581-33, § D(7) (Vernon 1964 & Supp. 1996); WASH. REV. CODE § 21.20.430(1), 21.20.430(2) (1989 & Supp. 1996) (provision for a "reasonable attorney's fee").

45. See discussion of broader seller status under state securities law *infra* part II.C.2.

46. OR. REV. STAT. § 59.115(3) (1988 & Supp. 1996). Arizona is the same. See ARIZ. REV. STAT. ANN. § 44-2003 (1994 & Supp. 1995).

47. 764 P.2d 1370 (Or. 1988).

48. *Id.* at 1371.

facts on which liability is based.”⁴⁹ In *Prince*, however, Justice Linde offered scant consolation to defendants found to have “materially aided a transaction”:

The drafters took pains to make clear that the relevant knowledge is of “the existence of the facts,” not the unlawfulness of a sale. These provisions may place upon persons . . . who materially aid in an unlawful sale of securities a substantial burden to exonerate themselves . . . but this legislative choice was deliberate . . . The defense against strict liability, in short, was to be a showing of ignorance,⁵⁰ not the professional role of the person who renders material aid in the unlawful sale.⁵⁰

Thus, in Oregon, the standard defense tactic, “my client was engaged only in rendition of customary professional services,” will not work.⁵¹

Business interests in Oregon lobbied to have the legislature amend the statute, but these efforts failed.⁵² Oregon thus remained one of the handful of jurisdictions in which knowledgeable attorneys continued to turn to state securities law even before “reform” efforts at the federal level. Of course, nowadays, after the passage of the Act, and with the tightening by federal courts, close examination of what state laws offer is an exercise to be undertaken in every jurisdiction.⁵³

C. A ROGUE BANK

Oregon requires a proceeds escrow in every offering conducted pursuant to Oregon securities laws.⁵⁴ Such escrows are also important elsewhere, commonly utilized in “All or None” or “Part or None” offerings. In such an offering, if 40 units are not sold (“All or None”) or some minimum number less than the whole, say, 25 of 40 units (“Part or None”), are not sold by a certain date, the escrow agent returns to all investors their subscription agreements and any payments they have made.⁵⁵

Proceeds escrow serve a number of functions. They insure, for example, that if a critical mass of capital is required for a proposed project, the project will not go forward unless the critical mass is achieved. Investors also take solace in the evidence produced that some number of other persons (25 or 40 in the example above) share their judgment that the

49. OR. REV. STAT. § 59.115(3) (1988 & Supp. 1996).

50. 764 P.2d at 1372.

51. Cf. *Hines v. Data Line Sys., Inc.*, 787 P.2d 8, 20 (Wash. 1990) (to hold attorneys liable in Washington, “‘something more’ must be shown than performance of the usual drafting and filing services provided by counsel”).

52. See, e.g., Gary M. Berne & Neil Bregenzer, *Participant Liability Under the Oregon Securities Law After Prince v. Brydon*, 68 OR. L. REV. 885 (1989) (recounting criticisms that a “parade of horrors” was likely to ensue from the decision).

53. See discussion *infra* part II.C.

54. OR. ADMIN. R. 441-65-150(3)(a),(b) (1995) provides, *inter alia*, that the proceeds of the sale of securities pursuant to the regulations must be segregated into “fiduciary trust accounts” and that the escrow’s terms must include instructions that the funds are to be held “for the benefit of investors.”

55. The working of these types of offerings was described recently by the Fifth Circuit in *Banc One Capital Partners Corp. v. Kneipper*, 67 F.3d 1187, 1192-93 (5th Cir. 1995).

offering has merit.⁵⁶

A number of older federal court decisions hold that manipulation of a proceeds escrow is a major sin, actionable under federal securities laws.⁵⁷ Proceeds escrows and proper use of them are important in securities offerings.

Classic Christmas Trees, Inc. ("Classic") and its owners, the Heater family, saw a downturn ahead in Christmas tree prices.⁵⁸ Previously, the Heaters had given a security interest in their trees to Key Bank. Key Bank was pressing for payment of the indebtedness so secured. Classic's owners then received a visit from a Michigan promoter who had syndicated several Christmas tree plantations located in that state. The owners saw an alternative to bankruptcy—syndication. They joined forces with the Michigan promoter to sell their Christmas tree operation to area investors.

The offering provided that a proceeds escrow be established. Until thirty-five units were sold, no funds would be released to Classic's owners. If, by the end of November, the units had not been sold, investors would also receive their money back.

The Classic offering proved to be a sticky offering. By early August, only fourteen or so units had been sold, and Key Bank was threatening foreclosure. An attorney for Classic then arranged for yet a third bank to transfer into escrow bank funds sufficient for the escrow office to state that the offer was "fully funded." Over \$1 million was transferred—transferred only in the sense of accounting entries in correspondent accounts that were reversed twenty minutes later. Escrow was broken, the funds were disbursed, and Key Bank was sent on its way.

The following day the bank officers opened a new escrow. Legitimate selling commenced anew right where it had left off. The offering still proved to be sticky. When November 31 arrived, the requisite number of units still had not been sold. The lawyers and the bank simply extended the escrow agreement, turning blind eyes to the obvious passage of a critical deadline.

The Christmas trees were overgrown. They were not marketable for use in homes with ceilings under twelve feet. Also, as predicted, Christmas tree prices headed downward. Classic Christmas trees folded; investors lost everything and brought a lawsuit.

56. See *Svalberg v. SEC*, 876 F.2d 181, 183 (D.C. Cir. 1989) ("The all-or-nothing provision serves not only to ensure that the issuing firm has sufficient funds to complete its project, but also to give investors some reasonable indication that they are paying a fair market price for their investment.").

57. See, e.g., *C.E. Carlson, Inc. v. SEC*, 859 F.2d 1429, 1434 (10th Cir. 1988); *SEC v. Coven*, 581 F.2d 1020, 1028-29 (2d Cir. 1978), *cert. denied*, 440 U.S. 950 (1979); *A. J. White & Co. v. SEC*, 556 F.2d 619, 622-23 (1st Cir.), *cert. denied*, 434 U.S. 969 (1977). In addition, Rule 10B-9 defines manipulation of an all or none offering as a "manipulative or deceptive device or contrivance." 17 C.F.R. § 240.10b-9 (1996).

58. These events are recounted from *Ainslie v. Spolyar*, No. 8912-17730 (Cir. Ct. of Multnomah County, Or. 1989), and *Ainslie v. First Interstate Bank Or.*, No. 9009-05735 (Cir. Ct. of Multnomah County, Or. 1990).

In discovery, plaintiffs' counsel served a request for production on the escrow bank for files of other securities offering escrows in which the bank had provided services. The bank showed counsel to a file room, stating "good luck." Yet counsel found the few proverbial needles in the haystack.

The bank had acted as escrow agent in five or so failed ornamental shrubbery farm partnerships. In those partnerships, the promoters and lawyers had played fast and loose with proceeds escrows as well, and the bank had permitted them to do so. For example, if at the deadline, an offering had sold only 20 of 35 units, the bank would allow the promoter and his family to purchase the remainder of the units. The promoter would kite checks to do so, repaying the "borrowing" when on the following day the bank distributed the proceeds of the escrow to him.

The common link in all of this turned out to be two lawyers, one of whom was a professor at the local law school. Counsel also found that the temporary parking of funds in order to break securities proceeds escrows had occurred around the country. At least one court had found the professionals involved liable for use of such "flash loans."⁵⁹

Again, the complaint progressed through several amendments to reflect what had been learned in discovery. Most importantly, the bank's previous toleration of, and participation in, manipulation of escrows gave rise to a strong inference of a pattern, fulfilling RICO's requirement that predicate acts add up to a "pattern of racketeering activity."

The bank fought every step of the way. They seemed incensed by the thought that, while the banks' fees for its services were less than a thousand dollars, the bank could be held liable for millions of dollars. Of course, the reply that anything worth doing is worth doing well, did not sit well.

The case went to trial. The jury returned a \$10 million dollar plus verdict against the bank. The verdict reflected treble damages under RICO as well as attorneys' fees.

Marching toward trial right behind the Christmas tree case were cases brought on behalf of investors in the ornamental shrub farm deals that would have been stillborn but for the bank's toleration of manipulation of proceeds escrows.⁶⁰ That manipulation made a mockery out of Oregon's requirement that all offerings include as an integral part a proceeds escrow.

As with a national accounting firm, one hesitates to label a major respectable West Coast bank a "rogue." Within the bank, however, operating with little or no supervision, was a rogue department. The bank employees in that department consistently got too chummy with the per-

59. See *Florida Bar v. Calvo*, 630 So. 2d 548 (Fla. 1993) (upholding disbarment of attorney who arranged the flash loan), *cert denied*, 115 S. Ct. 58 (1994).

60. See *Achar v. First Interstate Bank Or.*, No. 9112-08430 (Cir. Ct. of Multnomah County, Or. 1991).

son over whom they were to be watchdogs, namely, promoters and attorneys who did securities transactions.

After the Act, of course, the case would have lost much force. The RICO allegations would have been dismissed insofar as they relied upon violations of securities laws as the predicate acts. Yet, this case, too, was brought in state court, and, under many state "little RICO statutes," violation of the securities laws remain predicate acts for purposes of civil suits under RICO.⁶¹

The proceeds escrow cases illustrate the point that rogue professionals may be found operating in some unlikely places—in a major bank, at a national accounting firm, within the offices of a prestigious law firm, or elsewhere. The elsewhere forms the remainder of this section of the Article.

D. ROGUES IN OTHER PROFESSIONS

The persons defrauded are not limited to investors in tax shelters or "get rich quick" schemes. In *Tolas v. National Life Insurance Co.*,⁶² a dental surgeon and his employees chose one of the most conservative investments possible for their pension plan: annuity contracts administered by the National Life Insurance Company of Montpelier, Vermont. Yet a rogue insurance agent who represented the company cashed in annuity contracts, embezzling \$750,000. The Vermont company's employees provided the money after the receipt of faxed documents. Had they insisted that the originals reach Montpelier, they easily could have detected that they were forgeries. Yet the insurance company retained counsel and resisted payment on grounds of contributory negligence. The surgeon had signed blank documents and checks that the insurance broker had asked him to execute. The surgeon often did so on Sundays because he and the rogue agent attended the same church.

Congress and conservative federal judges have now given defense attorneys so much ammunition that a pugnacious defendant stands a better than even chance of winning the most outrageous case, or at least wearing the plaintiff out and settling the case for much less than 100 cents on the dollar.

Rogue securities salesmen have always been a problem. *Harrison v. Dean Witter Reynolds, Inc.*⁶³ illustrates roguery and the difficulty of prosecuting cases these days. Two registered representatives, one a vice-president of Dean Witter, convinced over 100 investors that, as large brokers, the two had advantageous access to special municipal bond trading facilities at Dean Witter. They directed investors, including Harrison, to send

61. See, e.g., ARIZ. REV. STAT. ANN. § 13-2301(D)(4)(r) (1989 & Supp. 1995) ("intentional or reckless fraud in the purchase or sale of securities" listed as predicate act); OR. REV. STAT. § 166.715(6)(a)(A) (1990 & Supp. 1996) (violations of various sections of securities act, including antifraud rule, listed among predicate acts for Oregon RICO).

62. No. C 93-1647 (W.D. Wash. Nov. 24, 1993).

63. 79 F.3d 609 (7th Cir. 1996).

funds and correspondence to them at their private addresses to avoid a Dean Witter office rule which required that all mail be opened and checks removed in the cashier's cage.⁶⁴ Instead of investing in bonds, the two rogues invested in risky put options. After thirty months and large trading losses, the Ponzi scheme collapsed.

Dean Witter failed to detect the scheme even though the volume in the registered representative's trading account was extraordinary, which should have triggered an inquiry under Dean Witter's own rules. Instead of monitoring, Dean Witter awarded the two rogues plaques for "their outstanding broker accomplishments."⁶⁵

Harrison lost \$3.1 million in this Ponzi scheme operated right out of a major New York Stock Exchange member firm's branch office. Harrison sued and Dean Witter resisted all the way. It took Harrison two trips to the Seventh Circuit and several years to obtain a single cent. Finally, Judge Wood rejected Dean Witter's contention that "it did not directly or indirectly induce the acts constituting the violation" of securities law:

There is a sufficient basis in the record . . . for a reasonable jury to conclude that even within a sophisticated, well-known, and reputable company such as Dean Witter . . . there was a total lack of sufficient diligence, that the supervision was only very casual or grossly indifferent, and that Dean Witter totally ignored the obvious warning signs. In view of the high monetary stakes and the risks resulting from sophisticated and contriving minds, mere reliance on published rules and indifferent or superficial supervision of Kenning and Carpenter's activities while providing income for Dean Witter could be viewed by a jury as reckless under the instructions.⁶⁶

Because rogue brokers have been encountered so frequently in the securities industry, the SEC has announced a special program which subjects firms that hire or retain rogue brokers to "increased scrutiny" of their hiring and retention practices.⁶⁷

Eighteen months after the announcement of that program, the SEC and the Department of Justice held a joint press conference to announce the indictment of rogue securities brokers in ten different cases around the country.⁶⁸ The cases ranged from defrauding forty-two elderly investors of \$950,000 by selling phony securities to registered representatives

64. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 190 (1976) (involved similar facts). Leston Nay, president of a small Chicago securities firm, ran a Ponzi scheme. By virtue of Nay's "mail rule," his employees never discovered the scheme. Employees were forbidden to open mail addressed to Nay personally. As a result, he was able to run the scheme out of his firm's offices for a great number of years.

65. *Harrison*, 79 F.3d at 612.

66. *Id.* at 615.

67. *Firms with "Rogue" Brokers May Face Increased Scrutiny, Official Says*, 26 Sec. Reg. & L. Rep. (BNA) 356 (Mar. 11, 1994) (reporting address by Mark Fitterman, Associate Director of the SEC Division of Market Regulation, at the Practicing Law Institute "SEC Speaks" Conference on March 5, 1994).

68. *SEC, Justice Announce Indictments of Several "Rogue" Brokers*, 27 Sec. Reg. & L. Rep. (BNA) 1833 (Dec. 1, 1995) (comments of Attorney General Janet Reno and SEC Chairman Arthur Levitt at a news conference on November 30, 1995).

to outright theft of client funds in amounts up to hundreds of thousands of dollars without even the pretext of phony securities.⁶⁹

The question that arises is, after "reform" of the securities laws by Congress and conservative federal judges, what are some efficient, cost-effective avenues to pursue in seeking civil recoveries on behalf of victims of rogue professionals such as these?

II. ALTERNATIVES TO TRADITIONAL CLASS LITIGATION UNDER FEDERAL SECURITIES LAW

A. CAN THE PUTATIVE DEFENDANT BE HELD AS A PRIMARY VIOLATOR?

Pinter v. Dahl cuts back the reach of Section 12 of the Securities Act pursuant to sellers and solicitors. *Gustafson v. Alloyd* further limits its usefulness. *Central Bank* eliminates aiding and abetting liability under Rule 10b-5. Expert observers believe that *Central Bank* presages an end to other forms of implied secondary liability such as conspiracy and respondeat superior. Are there means left to hold liable culpable collateral participants in securities transactions that are proven to have been fraudulent?

Answering the question first requires a return to principles:

Many defendants are only secondarily present in a transaction. They will have been engaged in "customary business activities, such as loaning money, managing a corporation, preparing financial statements, distributing a press release, completing brokerage transactions, or giving legal advice. . . ."

If they are liable, however, collateral participants often are primarily liable under at least one, and often several, theories advanced by a plaintiff. Many commentators, lawyers, and judges, tend wrongly to equate collateral participation and the secondary presence associated with it to so-called secondary liability.

Collateral participants are often alleged to be primarily liable and, along with primary liability generally, the area of primary liability for them has constantly expanded over the years.⁷⁰

Primary liability has expanded at common law. This is seen in the expansion of accountants' liability for negligence to third parties. More recently, the expansion has been evident in other professions such as lawyers.⁷¹ Primary liability has also expanded as a matter of federal securities law. *Central Bank* itself spoke of the door as being ajar:

69. Some of the acts and practices of attorneys are described in Simon M. Lorne & W. Hardy Callcott, *Administrative Actions Against Lawyers Before the SEC*, 50 BUS. LAW. 1293, 1317-26 (1995).

70. Branson, *Collateral Participant Liability Under the Securities Laws—Charting the Proper Course*, *supra* note 1, at 329-30 (quoting David S. Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 632 (1972)).

71. See discussion *infra* part II.E.

The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5.⁷²

Federal courts seem to find collateral participants potentially liable as primary violators in at least three instances: (1) when they themselves have made misstatements to investors; (2) when they have materially participated in misstatements made by others; and (3) when they have had direct contact with plaintiff investors in circumstances calling for them to correct misstatements or nondisclosures of which they are aware.

1. *Makes a Statement*

Courts are taking a broader view of who makes a statement. The traditional defense was that rendition of an opinion letter by an attorney or provision of accounting statements by accountants was for the benefit of the issuer of securities and not the investors.⁷³ Today, with increasing frequency, courts are recognizing that an opinion letter or accounting statement speaks directly to investors.⁷⁴

For example, in *Kline v. First Western Government Securities, Inc.*,⁷⁵ the Third Circuit held that "professionals and others with similar access to information must disclose data that calls into question the accuracy of an opinion."⁷⁶ Thus, it may be an open question how much a professional can turn a blind eye to what she suspects is incomplete information. But a professional cannot turn a blind eye toward what she knows is contradictory or impeaching evidence, for that converts the blind eye case to the false impression one.

Other courts have made this distinction in slightly different terms. An opinion letter or private placement memorandum does not involve the good faith rendition of professional services when the professional knows the truth to be at variance with representations in the document. Moreover, the resulting liability is primary liability that survives *Central Bank*.⁷⁷

72. 114 S. Ct. at 1455.

73. Of course, the linchpin of every such argument is Judge Cardozo's opinion in *Ultramares Corp. v. Touche*, 174 N.E. 441, 444 (N.Y. 1931) (holding professionals liable to those other than with whom they had a professional relationship would result in "liability in an indeterminate amount for an indeterminate time to an indeterminate class").

74. A related concept is the "group published" theory. Those officials of an entity (managing partners, directors, officers) who are actively involved in formulation of the entity's public pronouncements may be held primarily liable as a member of the group that spoke in the documents containing the deficient disclosure. See, e.g., *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1440 (9th Cir. 1987); *Morse v. Abbott Labs.*, 756 F. Supp. 1108, 1111 (N.D. Ill. 1991); Steinberg, *supra* note 27, at 500.

75. 24 F.3d 480 (3rd Cir.), *cert. denied*, 115 S. Ct. 613 (1994).

76. *Id.* at 487.

77. See *Walco Inv., Inc. v. Thenen*, 881 F. Supp. 1576, 1581-83 (S.D. Fla. 1995).

2. *Participates in a Statement Made by Another*

In *In re Software Toolworks, Inc.*,⁷⁸ the SEC had suggested that Toolworks disclose preliminary results for the quarter ending June 30. In letters on July 1 and 4, Toolworks told the SEC that the information was not available. Deloitte & Touche participated in the drafting of those letters which it knew to be false because Toolworks had provided Deloitte & Touche with financial data for that quarter. Judge Cynthia Holcomb Hall held that, post *Central Bank*, Deloitte & Touche could be held as a primary violator:

Despite *Central Bank*, we nevertheless consider this issue because the plaintiffs' complaint clearly alleges that Deloitte is primarily liable In fact, the July 1 SEC letter stated that it "was prepared after extensive review and discussions with . . . Deloitte" and actually referred the SEC to two Deloitte partners for further information. Similarly, the plaintiffs presented evidence that Deloitte played a significant role in drafting and editing the July 4 SEC letter. This evidence is sufficient to sustain a primary cause of action under section 10(b) and, as a result, *Central Bank* does not absolve Deloitte on these issues.⁷⁹

In other words, if a collateral participant plays "a significant role" in drafting a document promulgated by another, knowing the document to be false or deliberately misleading, the collateral participant may be held liable as a primary violator. Accountants, for example, have been held liable as primary violators when they participated in preparation of a false prospectus issued by another⁸⁰ or permitted an auditing client to issue financial statements the accountants allegedly knew to be false.⁸¹

3. *Has Direct Contacts with the Plaintiffs or Members of the Plaintiff Class*

The Sixth Circuit evolved the "direct contacts" test of primary liability.⁸² The test seems to graft "direct contacts" onto the test for primary liability prevailing elsewhere, that is, that the collateral participant participated in drafting or revising documents he knew to be false or deliberately misleading. Thus, for example, those who are deemed to have "furnished documents" to investors may be held primarily liable.⁸³

Direct contact with investors seems an appropriate addition to the test of primary liability. Direct contact provides an occasion upon which

78. 38 F.3d 1078 (9th Cir. 1994).

79. *Id.* at 1090 n.3.

80. See *Cashman v. Coopers & Lybrand*, 887 F. Supp. 425 (N.D. Ill. 1995).

81. See *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398 (N.D. Cal. 1995).

82. See *Molecular Technology Corp. v. Valentine*, 925 F.2d 910, 917-18 (6th Cir. 1991) (Utah attorney who implemented a going public by the back door scheme and participated in drafting various fraudulent documents).

83. *SEC v. Washington County Util. Dist.*, 676 F.2d 218, 223-24 (6th Cir. 1982); Steinberg, *supra* note 27, at 500-01.

events call for the collateral participant to disclose substantial misgivings she has about the issuer's disclosures.

The Western District of Michigan held liable an attorney and law firm whose work for, and involvement in, a corporation far exceeded the "daily grist of the mill."⁸⁴ The court summarized the Sixth Circuit law on the subject, noting that "direct contacts . . . may include direct dealing with the 'other side'—in this case, direct dealing with the purchasers of Rospatch stock."⁸⁵ The court went on also to conclude that "direct participation in preparation of documents constitutes 'direct contacts' under the law of the Sixth Circuit."⁸⁶

B. BRING ANY FEDERAL COURT PROCEEDING AS AN INDIVIDUAL OR GROUP RATHER THAN CLASS ACTION

Following the amendment of Federal Rule of Civil Procedure 23 in 1966, the class action boomed.⁸⁷ Another driving force behind the boom was the attorney's fee that could be obtained in class actions, often a substantial percentage of the recovery, based upon "common fund" grounds.⁸⁸

In the late 1970s, however, courts began severely to criticize fee awards in class action cases.⁸⁹ The lodestar method, based upon the number of attorney hours billed multiplied by the usual hourly rate (the lodestar) with a modest multiplier, such as, 1.3, applied to that sum,⁹⁰ overtook the percentage of recovery as the method of choice in approving fee awards in class action cases.⁹¹ The prevalence of the lodestar method may have meant lower fees. It also required the expenditure of a substantial amount of time in every case, whether needed or not, and awarded nothing to compensate class counsel for cases in which little or no fee had been obtained.

As a result of the lodestar method and general forfeiture of control to the judge in class actions, a common tactic in the early 1980s became to litigate securities cases as individual actions on behalf of as many named plaintiffs who would join suit. A one-third contingent fee in representing

84. The phrase originates in *Camp v. Dema*, 948 F.2d 455, 463 (8th Cir. 1991).

85. *In re Rospatch Sec. Litig.*, [1992 Transfer Binder] Sec. L. Rep. (CCH) ¶ 96,939 at 93,978 (W.D. Mich. July 8, 1992).

86. *Id.*

87. See, e.g., Arthur R. Miller, *Of Frankenstein Monsters and Shining Knights: Myth, Reality, and the "Class Action Problem"*, 92 HARV. L. REV. 664, 665, 669-76 (1979).

88. See *Sprague v. Ticonic Nat'l Bank*, 307 U.S. 161 (1939) (attorney's fee from common fund approved as a matter of general equity jurisprudence in the United States).

89. The cases marking a first turning to the lodestar method are *Lindy Bros. Builders, Inc. v. American Radiator & Standard Sanitary Corp.*, 487 F.2d 161, 166-68 (3rd Cir. 1973), *appeal after remand*, 540 F.2d 102 (3rd Cir. 1976); *City of Detroit v. Grinnell Corp.*, 495 F.2d 448, 469-71 (2d Cir. 1974).

90. For a summary of the process of calculation, see DOUGLAS M. BRANSON, *CORPORATE GOVERNANCE* 11.41, at 722-23 (1993).

91. FED. R. CIV. P. 23(e) mandates that "[a] class action shall not be dismissed or compromised without the approval of the court." A substantial part of that approval process involves examination of class counsel's proposed fee.

one-half of the investors was preferable to the 8%, 19%, or 12% of the recovery the lodestar might yield in a class action. Moreover, the individual or group action did not present the same opportunity for intervenors, and their counsel, to opt in, often to seek a share of the fee. In the 1980s, many of the limited partnership and other tax shelter cases were litigated in this way, that is, as actions on behalf of numbers of named plaintiffs (30 to 40, 70 to 80) rather than as class actions.

Most recently, the percentage of recovery method has become prevalent again.⁹² With it came a reprise of the class action and the demise of the action on behalf of numerous named plaintiffs (the group action).

The last twist and turn in the story is the Private Securities Litigation Reform Act of 1995 (the "Reform Act of 1995").⁹³ As a result of the Reform Act of 1995, it seems wise to avoid class litigation in the securities area and to reprise again the group action when that alternative seems feasible.

The Reform Act of 1995 does many bad things to class actions, only a few of which need be mentioned here.⁹⁴ One negative for plaintiff's counsel is the mandatory quest in class actions for "the most adequate plaintiff" ("MAP") and the upset provision once she is found. Within twenty days of filing a class action complaint, plaintiff's counsel must publish a notice of the pendency of the action "in a widely circulated national business-oriented publication, or wire service."⁹⁵ Within the ensuing ninety days, the court must entertain motions by any purported class members to take over as lead plaintiff. In that process, the court must presume that the movant "with the largest financial interest in the relief sought" is the MAP.⁹⁶ If the presumption is not overturned, an upset takes place. The MAP "upsets" the named plaintiff as lead plaintiff and

92. One of the most vocal criticisms of the lodestar method was by Judge Marilyn Patel in *In re Activision Sec. Litig.*, 723 F. Supp. 1373, 1375 (N.D. Cal. 1989) (approving a return to a percentage of the recovery attorney fee formula):

Is this [lodestar] process necessary? Under a cost-benefit analysis, the answer would be a resounding "No!" Not only do the Lindy and Kerr-Johnson analyses consume an undue amount of court time . . . but, in fact, it may be to the detriment of the class members. They are forced to wait until the court has done a thorough, conscientious analysis of the attorneys' fee petition. [C]lass members may suffer a further diminution of their fund when a special master is returned and paid from the fund Where attorneys must depend on a lodestar approach there is little incentive to arrive at an early settlement.

In some circuits, a 25% fee has become presumptive in the settlement of securities and corporate class actions. See, e.g., *In re Pacific Enters. Sec. Litig.*, 47 F.3d 373, 379 (9th Cir. 1995) ("twenty-five percent is the 'benchmark' that district courts should award in common fund cases" but awarding 33% "because of the complexity of the issues and risks"). But see *In re Boesky Sec. Litig.*, 888 F. Supp. 551, 559-60 (S.D.N.Y. 1995) (district judge view that lodestar is mandatory in the Second Circuit).

93. See Reform Act, *supra* note 8.

94. See Branson, *supra* note 10, for a more complete list, including the efforts to eradicate professional plaintiffs.

95. See Reform Act, *supra* note 8, § 101(a).

96. *Id.*

her counsel becomes lead counsel.⁹⁷

One stratagem in class actions could be a maintenance by the defense bar of a stable of "sweetheart plaintiffs." The best sweetheart plaintiffs would own a substantial number of shares (1000 or 5000) in order to assure a greater likelihood of success in the quest to upset the named plaintiff. As MAP, the sweetheart plaintiff and her counsel would be disposed to reach a quick and easy disposition of the litigation.

The upset provisions, and their use either by defense lawyers or rival plaintiffs' attorneys attempting to muscle in on the action, are alone enough to drive class counsel back to the group action in cases in which it is feasible. In terms of fees, those attorneys may give up more than in times when the lodestar method was prevalent and courts were skeptical of fee awards.

A makeweight may be that, paradoxically, without a class component to litigation, an attorney may be able to obtain a fee from a corporate defendant based upon common benefit or corporate therapeutics grounds while the Reform Act of 1995 prohibits such an award in a securities class action. The Reform Act of 1995 limits the fee award to class counsel to a percentage of "amounts actually paid," presumably to rule out fee shifting based upon "corporate therapeutics" or cosmetic relief in federal securities class actions.⁹⁸

Yet the most authoritative corporate court in the land, the Supreme Court of Delaware, has held that a class or derivative action component is not a necessary prerequisite to a fee award on common benefit grounds. "We hold," the court has stated, "that, under certain circumstances, counsel fees may be awarded to an individual shareholder whose litigation effort confers a benefit upon the corporation, or its shareholders notwithstanding the absence of a class or derivative component."⁹⁹ The focus is on the benefit shared by others, not upon the form of the action.

More than ever, the class action is to be avoided in federal securities cases. A somewhat imperfect substitute is the group action. A less imperfect substitute may be a group action with a common benefit or corporate therapeutics component.

C. TURN TO STATE SECURITIES LAWS

There are several advantages and two disadvantages to the state securities laws.

97. See *id.* (amending 15 U.S.C. § 772-1) ("The most adequate plaintiff shall, subject to the approval of the court, select and retain counsel to represent the class.").

98. *Id.* ("Total attorneys' fees and expenses awarded by the court to counsel for the plaintiff class shall not exceed a reasonable percentage of the amount of any damages and prejudgment interest actually paid the class.").

99. *Tandycrafts, Inc. v. Initio Partners*, 562 A.2d 1162, 1163 (Del. 1989).

1. Availability of Attorney's Fees

In cases arising under federal securities laws, plaintiff's counsel looks primarily to any common fund created for his fee, which lessens the net recovery for investors. Only if there also exists a common benefit, or corporate therapeutics component to the case, will any portion of the fee be shifted to the defendant. By contrast, as has been seen,¹⁰⁰ most state securities laws provide for fee shifting. Plaintiff investors receive a full recovery and the losing defendant must pay the investors' attorney's fees.

2. Broader Seller Status

Thirty-seven jurisdictions have adopted the 1956 version of the Uniform Securities Act.¹⁰¹ Six jurisdictions have adopted the revised 1985 Uniform Securities Act, three being states that had the prior act and upgraded to the newer version.¹⁰² Three of the six, though, do represent new adoptions. Thus, the Uniform Securities Act is the law of forty jurisdictions. Of the remaining states, several, including New York and California, have home grown statutes that are beyond the scope of a symposium article.¹⁰³

The civil liability provision of the 1956 Uniform Act provides that "[a]ny person who . . . offers or sells a security in violation of [registration requirements] . . . is liable to the person buying the security from him."¹⁰⁴ The seller or offeror is also liable if he "offers or sells a security by means of an untrue statement of a material fact or any omission to state a material fact."¹⁰⁵ The question that arises is how expansive are the terms "seller," and "any person who offers or sells." The few authorities that have examined the question are split. Some hold that state law notions of who is a seller are broader than at least the point of sale analysis of *Pinter v. Dahl*. Other state courts have followed *Pinter v. Dahl* in determining the scope of the term "seller."

In the latter category are several state intermediate appellate courts as well as a handful of federal courts making educated *Erie* guesses as to state law.¹⁰⁶

100. See *supra* note 44 and accompanying text.

101. See UNIFORM SECURITIES ACT, 7B U.L.A. 509 (1985).

102. See *id.* 1995 Supplement at 87 (Table regarding adoption of 1995 revised act); see generally HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS 359 (1985).

103. They are perhaps also beside the point. New York courts have refused to imply a private right of action pursuant to New York's Martin Act. See *CPC Int'l, Inc. v. McKesson Corp.*, 514 N.E.2d 116, 118 (N.Y. 1987); *Independent Order of Foresters v. Donaldson*, 919 F. Supp. 149, 153 (S.D.N.Y. 1996). California's statute is of greater but nonetheless limited use to plaintiffs because of strict privity and high state of mind requirements. See, e.g., *In re ZZZZ Best*, Blue Sky L. Rep. (CCH) ¶ 72,981, at 73,838 (C.D. Cal. 1989); *Lubin v. Sybedon Corp.*, 688 F. Supp. 1425, 1453 (S.D. Cal. 1988).

104. UNIFORM SECURITIES ACT § 410(a)(1), 7B U.L.A. 643 (1985).

105. *Id.* § 410(a)(2).

106. See *State v. Williams*, 390 S.E.2d 746, 749 (N.C. Ct. App. 1990) (applying *Dahl* to reverse attorney's securities-fraud conviction); *Zendell v. Newport Oil Corp.*, 544 A.2d 878, 882 (N.J. App. 1988) (adopting *Dahl* sale-solicitation as the test of expanded seller status);

By contrast, the supreme courts of two leading Blue Sky states, Kansas and Washington, have consciously chosen to take a different fork in the road. Those two courts have retained the pre-*Pinter v. Dahl* "substantial factor" test of expanded seller. The Supreme Court of Kansas noted that "although the same terms are used in the federal and state statutes . . . , the basic framework in which the statutes are formulated shows a different approach should be employed."¹⁰⁷

In Washington, the supreme court first read *Pinter v. Dahl* incorrectly, conceiving it as evolving an ultra narrow "strict privity analysis of the term 'seller.'"¹⁰⁸ For that reason, the court rejected it. The Washington court noted that "the Supreme Court's construction of a similarly worded federal statute, although often persuasive, 'is not controlling on our interpretation of a state statute.'"¹⁰⁹ The court also decided that the Washington statute is to be construed more broadly than the federal statute, in part because state securities laws place more emphasis on protection of investors while the federal scheme is more intent on protection of the "integrity of the marketplace."¹¹⁰ Utilizing "substantial contributive factor" and "substantial factor-proximate cause" tests of who is a seller,¹¹¹ the court decided that allegations against the state auditor, who had certified certain aspects of a bond offering, required more development at the trial court level.¹¹²

Thus, states now seem to be falling on one of two sides of a great divide. One group of state judiciaries pays great heed to Section 415 of the Uniform Securities Act which admonishes that "[t]his act shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it and to coordinate the interpretation and administration of this act with the related federal regulation."¹¹³ That group regards as nearly dispositive what the federal courts have done.

The other group regards as more dispositive what other states have done and the differing purpose served by state regulation. One of those courts has found, for example, that the Uniform Securities Act provision does not require "imitation" of the federal scheme.¹¹⁴ The Supreme Court of Utah recently held that "[u]niformity with a significant majority

Allen v. Columbia Fin. Management Ltd., 377 S.E.2d 352, 356 (S.C. Ct. App. 1988) (applies *Dahl*). *Accord*, Abell v. Potomac Ins. Co., 858 F.2d 1104, 1115 (5th Cir. 1988) (applying *Dahl* as law of Louisiana), *cert. denied*, 492 U.S. 918 (1989); Capri v. Murphy, 856 F.2d 473, 478 (2d Cir. 1988) (applying *Dahl* as Connecticut law).

107. State *ex rel.* Mays v. Ridenhour, 811 P.2d 1220, 1230 (Kan. 1991) (upholding injunction against promoters of pyramid sales scheme despite their lack of participation in sales efforts).

108. Hoffer v. State, 776 P.2d 963, 964 (Wash. 1989).

109. *Id.* (quoting State v. Gore, 681 P.2d 227 (1984)).

110. *Id.* at 965 (relying on Haberman V. Washington Pub. Power Supply Sys., 744 P.2d 1032, 1049 (Wash. 1987)).

111. Hoffer v. State, 755 P.2d 781, 789 (Wash. 1988).

112. The contributive factor test was revisited and again upheld in *Hines*, 787 P.2d at 20 n.8.

113. UNIFORM SECURITIES ACT § 415, 7B U.L.A. 678 (1985).

114. Kittilson v. Ford, 608 P.2d 264, 265 (Wash. 1980).

of states," rather than allegiance to federal precedent, is its goal in construction of the Utah version of the Uniform Securities Act.¹¹⁵ Pre-*Pinter*, the Supreme Court of Alabama concluded that in the matter of determining who is a seller, and on other issues as well, "the Alabama Act goes beyond the federal act."¹¹⁶ Then, too, there exists a group of state legislatures that chose never to adopt Uniform Securities Act Section 415 in the first place.¹¹⁷

The great divide among states may become more pronounced. Commentators have suggested that states need not pay the deference that they have paid in the past to federal court decisions. A suggested point of departure has been the Supreme Court's excessively literal approach to statutory construction in the securities as well as other areas, an approach much less compelling for state courts.¹¹⁸

Likely to push state and federal regulation apart still more is the Fields legislation, now pending in the Congress. Over the objection of state regulators, Congress is soon to preempt the field in important areas such as regulation of mutual fund offerings and offerings of mid-size and larger public corporations.¹¹⁹ The legislation may cause state securities regulators to disregard federal court positions on many issues.

Depending upon the jurisdiction, state securities regulation may enable a plaintiff's attorney to cast a wider net in naming and holding liable collateral participants through broader state law notions of who is a seller. But that is not the only avenue state securities law offers.

3. *Express (but Limited) Aiding and Abetting Liability*

Another subsection of the Uniform Securities Act civil liability provision deals with persons other than sellers who may be held liable. The section is thus a modest express aiding and abetting provision that may include some, but not all, categories of frequently named collateral participants:

Every person who directly or indirectly controls a seller liable [for registration violations], every partner, officer, or director of such a seller, every person occupying a similar status or performing similar functions, every employee of such seller who materially aids in the sale . . . [is] liable . . . unless the non-seller who is so liable sustains the burden of proof that he did not know, and in [the] exercise of reasonable care could not have know, of the existence of facts by

115. *State v. Larsen*, 865 P.2d 1355, 1360 (Utah 1993).

116. *Foster v. Jesup & Lamont Sec. Co. Inc.*, 482 So. 2d 1201, 1207 (Ala. 1986).

117. For example, of the Pacific Rim states, Alaska, Hawaii, and Oregon never adopted the provision. See Branson, *Collateral Participant Liability Under State Securities Laws*, *supra* note 1, at 1050, 1051 n.138.

118. See generally Douglas M. Branson & Karl S. Okamoto, *The Supreme Court's Literalism and the Definition of "Security" in the State Courts*, 50 WASH. & LEE L. REV. 1043 (1993).

119. See, e.g., Mark Anderson, *House Plans to Vote on Bill to Revise Securities Laws*, WALL ST. J., June 17, 1996, at C-19; *Securities Regulation Bill Advances*, N.Y. TIMES, June 19, 1996, at D-1.

reason of which the liability is alleged to exist.¹²⁰

Under the South Carolina version of the statute, the Supreme Court of South Carolina listed four categories of potential defendants: (1) partners, officers, or directors (and de facto equivalents); (2) employees of the seller; (3) agents of the seller; (4) a broker dealer.¹²¹ A common legislative embellishment is to add the latter two categories.

Several states have broadened the provision considerably more by revising the list to include a catchall term. Oregon also holds liable "every person who participates or materially aids in the sale," regardless of whether they are a director, officer, employee, or the like,¹²² which can be read as broad express aiding and abetting liability. In Arizona, "[a]n action . . . may be brought against any person . . . who made, participated in or induced the unlawful sale or purchase."¹²³ Texas, too, broadens the provision's coverage but includes an additional scienter requirement, holding liable "[a] person who directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law materially aids a seller, buyer, or issuer."¹²⁴

A more common addition to the list is "every broker, dealer or agent who materially aids in the sale."¹²⁵ A means of further expansion of that type of provision is to shoehorn collateral participants who have aided the selling effort in some way into the term "agent" or "employee." In Washington, a federal judge refused to dismiss allegations against a national accounting firm that had certified financial statements of a failed oil and gas venture. The Court noted that "[u]nder these allegations Anderson could be considered an employee of the seller of the securities who materially aided the sales transaction."¹²⁶ State courts have differed on whether an attorney could have employee status.¹²⁷ An older Hawaiian decision takes a broad view of when agents will be liable under the Hawaiian version of the Uniform Securities Act.¹²⁸

120. UNIFORM SECURITIES ACT § 410(b), 7B U.L.A. 643 (1985).

121. *Atlanta Skin & Cancer Clinic, P.C. v. Hallmark Gen. Partners*, 463 S.E.2d 600, 603 (S.C. 1995).

122. OR. REV. STAT. ANN. § 59.115(3) (1988 & Supp. 1996); *see discussion supra* notes 42-52 and accompanying text.

123. ARIZ. REV. STAT. ANN. § 44-2003 (1994 & Supp. 1995). The statute has been applied to hold liable a business broker who omitted material information, *Strom v. Black*, 523 P.2d 1339 (Ariz. Ct. App. 1974), and an attorney who acted as a go-between in a stock sale, *Trump v. Badet*, 327 P.2d 1001, 1004 (Ariz. 1958).

124. TEX. REV. CIV. STAT. ANN. art. 581/-330F(2) (Vernon Supp. 1991).

125. *See, e.g.,* ALASKA STAT. § 45.55.930(c) (1994).

126. *Ackerman, Jablonski, Porterfield & De Ture v. Alhadeff*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,756, at 93,685 (W.D. Wash. Apr. 16, 1986).

127. *Compare Pottle v. Coffey*, Blue Sky Law Rep. (CCH) ¶ 73,226, at 74,449 (Alaska 1990) (attorney could be employee) *with* *Allen v. Columbia Fin. Management Ltd.*, 377 S.E.2d 352, 356-57 (S.C. Ct. App. 1988) (attorney could not be held as employee) *and* *Rendler v. Markos*, 454 N.W.2d 805 (Wis. App. 1990) ("agent" does not include attorney rendering legal advice or drafting documents).

128. *See Young v. Kwock*, 474 P.2d 285, 287 (Haw. 1970).

[A] corporation, bereft of both body and mind, can operate only through agents, and it is the agents who knowingly aid the illegal transaction that are jointly and severally liable.

A discerning analysis of when an attorney or other collateral participant becomes an agent "who materially aids in the sale or purchase" is by the Supreme Court of Indiana in *Johnson v. Colip*.¹²⁹ The court reversed dismissal of the attorney defendant under its umbrella test that a collateral participant is an agent "if his or her affirmative conduct or failure to act when reasonably expected to do so at a meeting of prospective investors made it more likely than not that the investors would purchase the securities."¹³⁰ Justice Sullivan then gave examples of when an attorney would become an agent and when he would not:

For example, if when called upon at the meetings, Colip primarily reassured investors that risks about which they expressed concern were unlikely to materialize, such behavior made it more likely than not that the investors would purchase On the other hand, if Colip's principal function at the meeting was to either temper the exuberance of the principal promoters (a frequent reason why lawyers are asked to accompany "road shows" promoting new securities' offerings) or to discuss the technical aspects of the partnership agreement . . . we think the facts are not susceptible to an inference that an attempt to effect the purchase or sale of a security occurred.¹³¹

The express aiding and abetting provision of the Uniform Securities Act may offer additional means by which to hold a rogue professional accountable. The language "materially aid in the sale," though, cuts the provision back and to a degree overlaps it with broadened seller status. For that and other reasons, then, the Uniform Securities Act's express aiding and abetting provision does not approach the elasticity of common law aiding and abetting.

4. *Lower State of Mind Requirements*

Under federal securities law, *Ernst & Ernst v. Hochfelder* requires a plaintiff to prove at least reckless of the conscious disregard to ground a damage recovery.¹³² One of the decision's reasons was that, although on its face Rule 10b-5 has no state of mind requirement at all, Rule 10b-5 can be no broader than the statute pursuant to which the rule was enacted. The statute uses the words "manipulative," "deceptive," and "contrivance." Justice Powell found special significance in "manipulative" as "a term of art" denoting "intentional or willful conduct designed to deceive or defraud investors."¹³³ State law versions of Rule 10b-5, how-

[Defendant] argues that "aids" means *inducing* the purchaser to buy and that the facts indicate that she took no part in the "selling" effort. . . . [S]ome jurisdictions have followed such reasoning . . . [but under Hawaii's statute] not merely the salesmen who induced the purchase but all officers, directors and agents who *in any way* contributed to the disposition of the securities are liable.

Id.

129. 658 N.E.2d 575, 576 (Ind. 1995).

130. *Id.* at 578.

131. *Id.* at 578-79.

132. 425 U.S. 185 (1976).

133. *Id.* at 199.

ever, containing the nearly no-fault language, were enacted by legislatures. The *Hochfelder* analysis does not apply. Under the Uniform Securities Act, then, damages can lie for negligent behavior.

For example, in *Kittilson v. Ford*,¹³⁴ the Washington Supreme Court regarded the similarity in language but difference in source as deciding the question: "[I]n contrast to the federal scheme, the language of Rule 10b-5 is not derivative but is the statute in Washington."¹³⁵ So many state courts have now decided the issue in the same way that the question may be said to be no longer an open one.¹³⁶ Allegations of mere lack of reasonable care will suffice under state laws, although the wisdom of proceeding against a collateral participant merely on such grounds may be questioned.¹³⁷

5. Disadvantage: No Implied Secondary (Aiding and Abetting) Liability

Post *Central Bank*, at least two state supreme courts have confronted arguments that broad aiding and abetting liability should be implied under their states' versions of the Uniform Securities Act.¹³⁸ Both courts have turned back the argument. The Connecticut Supreme Court regarded as important the fact that at the time of the Uniform Securities Act's approval and first adoption by states, federal courts had yet to imply aiding and abetting liability under the parallel federal antifraud rule, Rule 10b-5.¹³⁹ The first federal aiding and abetting decision, *Brennan v. Midwestern United Life Insurance Co.*,¹⁴⁰ was not published until 1966.

The Supreme Court of South Carolina thought that the Uniform Securities Act's provision of express (albeit limited) aiding and abetting liabil-

134. 608 P.2d 264 (Wash. 1980).

135. *Id.* at 265.

136. See, e.g., *State v. Shama Resources, Ltd. Partnership*, 899 P.2d 977, 982 (Idaho 1995) (Department of Finance "was not required to make a showing of scienter"); *State v. Larsen*, 865 P.2d 1355, 1359-60 (Utah 1993) ("Uniformity with a significant majority of states is achieved only by a 'no scienter' construction of the provision"); Branson, *Collateral Participant Liability Under State Securities Laws*, *supra* note 1, at 1046 nn. 112-14 (collecting pre-1992 cases).

137. See the conclusion in Branson, *Collateral Participant Liability Under State Securities Laws*, *supra* note 1, at 1066:

The low and across-the-board negligence state of mind standard in Uniform Securities Act jurisdictions may be a delusion rather than a benefit. Judges are loath to find liable, for mere lack of reasonable care, collateral participants in securities transactions. So judges, especially federal judges reviewing *Erie* or pendant state securities act claims, tend to [act in ways inimical to plaintiffs].

138. See *Connecticut Nat'l Bank v. Giacomini*, 659 A.2d 1166, 1177 (Conn. 1995); *Atlanta Skin*, 463 S.E.2d at 601.

139. See *Connecticut Nat'l Bank*, 659 A.2d at 1174, 1177 ("We hesitate to recognize greater liability under CUSA than that provided under federal securities law at the time that the Uniform Act was drafted, especially where CUSA expressly delineates secondary forms of liability such as aider and abettor liability.").

140. 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

ity precluded also implying aiding and abetting liability.¹⁴¹ Making educated *Erie* guesses about state securities laws, federal judges are coming to the same conclusion.¹⁴² There seem to be no recent decisions to the contrary, implying broader secondary civil liability as a matter of state securities law.

6. *Disadvantage: No Implied Cause of Action Under the General Antifraud Rule*

Plaintiffs have sought to escape the constraints of the express aider and abettor list in Section 410 of the Uniform Securities Act by arguing parity with the federal scheme. That is, they have argued that, since under Rule 10b-5 federal courts have implied a right of action, under Section 100 of the Uniform Securities Act state courts should imply a cause of action.

Plaintiffs do so, however, as a means to an end. The end sought then is further implication and overlaying of implied aider and abettor liability on statutory state antifraud rules. Thus, the court decisions discussed in the previous subsection are indirect holdings that no implied right of action exists. Under the Uniform Securities Act, all civil liability flows from the express civil liability provision, Section 415, although the underlying substantive offense may be grounded on any of a number of the Act's substantive commands (antifraud rule, registration requirements, broker dealer registration provisions, and so on).

Very few decisions have directly confronted the implication of a private right of action under state antifraud statutes.¹⁴³ The question is a complex one, with a number of arguments for and against,¹⁴⁴ and beyond the scope of this symposium piece. Suffice it to say that the tide runs relatively strongly against any such implication of a private right of action, as it does against implying aider and abettor secondary liability.

D. TURN TO STATE CORPORATE LAW

Although no implied aiding and abetting liability may exist under state securities law, aiding and abetting liability is alive and well as a matter of state corporation law. The area has received little summary or analysis by commentators¹⁴⁵ but is well recognized by a number of courts.

In an early decision, the Delaware Chancellor held that:

141. See *Atlanta Skin*, 463 S.E.2d at 604 ("the very existence of an express 'materially aids' civil remedy in § 35-1-1500 implicitly undermines the notion of an implied cause of action"). The Connecticut Supreme Court also relied on this ground. See *Connecticut Nat'l Bank*, 659 A.2d at 1177.

142. See, e.g., *Broadview Fin., Inc. v. Entech Management Servs. Corp.*, 859 F. Supp. 444, 453 (D. Colo. 1994).

143. An exception is *Naye v. Boyd*, Fed. Sec. L. Rep. (CCH) ¶ 92,980 (W.D. Wash. Oct. 20, 1986) (finding no implied action to exist).

144. Some of those arguments are summarized in Branson, *Collateral Participant Liability Under State Securities Laws*, *supra* note 1, at 1062-66.

145. But see DOUGLAS M. BRANSON, CORPORATE GOVERNANCE §§ 10.09, 10.10 (1993).

The legal theory [of aiding and abetting breaches of fiduciary duty] is sound. The directors of a corporation stand in a fiduciary relationship . . . [a]nd one who knowingly joins with any fiduciary, including corporate officials, in a breach of his obligation is liable to the beneficiaries of the trust relationship.¹⁴⁶

In *Laventhol, Krekstein, Horwath & Horwath v. Tuckman*,¹⁴⁷ the Supreme Court of Delaware placed its imprimatur on the concept, stating that "if outside experts, on whom many must depend for the integrity of corporate affairs, knowingly conspire with self-dealing fiduciaries to defraud those very persons who in practicality must rely on their advice, it is difficult to see why the same trust principles of *Bovay* should not apply."¹⁴⁸ The court thus held that not only could outside accountants be held liable but that the only applicable time bar was laches and not the shorter statute of limitations. Very recently, the theory that an attorney could be held liable for aiding and abetting violations of fiduciary duty was accepted by the Court of Appeals of Maryland.¹⁴⁹

Many securities fraud cases involve self dealing or outright theft by partners, general partners, corporate officers, or promoters, all of whom are fiduciaries under state law. Often, their defalcations or acts of self-dealing are assisted by collateral participants who know of the wrongdoing and turn a blind eye, or even aid in creating a false appearance or impression. Aiding and abetting under states' corporate or partnership laws thus becomes a useful and, indeed, valuable tool. The questions that remain are two: (1) does *Central Bank* potentially undermine aiding and abetting under state law as well?; and (2) what are the disadvantages of the theory?

As to the first question, *Central Bank* rejects the graft of a common law concept, aiding and abetting, onto express or implied statutory liability. Hence, the antidote to *Central Bank* is that state corporate fiduciary law is wholly common law in origin. *Central Bank's* reasoning is inapposite. It is fitting that the state fiduciary law's gaps be filled by other well-known common law theories and devices.

The greater obstacle may be that any action to vindicate a breach of fiduciary duty is derivative, because at least in the corporate setting, the duty owed is to the corporation rather than to the investors. An action for aiding and abetting a breach of fiduciary duty could thus be conceived of as derivative as well. As such, the action may be sidetracked or derailed altogether by use of the special litigation committee device. Even if the action is not derailed, the recovery, if any, would go to the corporate treasury rather than to the investors. Of course, in the passage quoted from the Delaware Chancellor's opinion, the Chancellor expressly

146. *Penn Mart Realty Co. v. Becker*, 298 A.2d 349, 351 (Del. Ch. 1972).

147. 372 A.2d 168 (Del. 1976).

148. *Id.* at 170.

149. See *Alleco v. Weinberg Found.*, 665 A.2d 1038, 1049 (Md. 1995) ("Aider and abettor tort liability . . . has been uniformly recognized . . ." Finding, however, that there had been no underlying primary violation for the defendant attorney to aid and abet.).

stated that the aider and abettor "is liable to the beneficiaries of the trust relationship."¹⁵⁰

E. TURN TO THE COMMON LAW OF NEGLIGENT MISREPRESENTATION

The liability to third parties of makers of a statement negligently made is a subject worthy of an entire treatise and one has recently been published on that subject.¹⁵¹ Historically, courts have lead the way in finding accountants liable to third parties who have relied upon financial statements certified or compiled by those accountants. By contrast, other categories of professionals, including most notably lawyers, have been relatively immune from such liability.¹⁵²

Today, however, no profession is immune from such liability, although the extent of the liability may vary among jurisdictions.¹⁵³ Even attorneys who recklessly render opinion letters upon which third party investors rely, or who prepare private placement memoranda or other disclosure documents, knowing them to be materially false, are being held liable to third parties.¹⁵⁴ Liability can extend to appraisers of assets,

150. See *supra* text accompanying note 148.

151. See JAY M. FEINMAN, *ECONOMIC NEGLIGENCE: LIABILITY OF PROFESSIONALS AND BUSINESSES TO THIRD PARTIES FOR ECONOMIC LOSS* (1995).

152. See, e.g., Gary Lawson & Tamara Mattison, *A Tale of Two Professions: The Third-Party Liability of Accountants and Attorneys for Negligent Misrepresentation*, 52 OHIO ST. L.J. 1309 (1991); Nancy Lewis, *Lawyers' Liability to Third Parties: The Ideology of Advocacy Reframed*, 66 OR. L. REV. 801 (1987).

153. The two main competing positions are liability to all foreseeable third parties, as in much of tort law, or more limited liability to a "person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it." RESTATEMENT (SECOND) OF TORTS § 552(2)(a) (1976) ("Information Negligently Supplied For the Guidance of Others"). See generally FEINMAN, *supra* note 151, at 131-48.

Among the accountant cases, the following posit liability to all foreseeable third parties: *Brumley v. Touche, Ross & Co.*, 463 N.E.2d 195, 200 (Ill. App. Ct. 1984); *Bonhiver v. Graff*, 248 N.W.2d 291, 298 (Minn. 1976); *H. Rosenblum, Inc. v. Adler*, 461 A.2d 138, 153 (N.J. 1983); and *Citizens State Bank v. Timm, Schmidt & Co.*, 335 N.W.2d 361, 366 (Wis. 1983).

Authorities adopting the Restatement position include *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992); *First Florida Bank, N.A., v. Max Mitchell & Co.*, 558 So. 2d 9 (Fla. 1990); *Badische Corp. v. Caylor*, 356 S.E.2d 198 (Ga. 1987); *Spherex, Inc. v. Alexander Grant & Co.*, 451 A.2d 1308 (N.H. 1982); *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 367 S.E.2d 609 (N.C. 1988); *Haddon View Inv. Co. v. Coopers & Lybrand*, 436 N.E.2d 212 (Ohio 1982); *Shatterproof Glass Corp. v. James*, 466 S.W.2d 873 (Tex. Civ. App.—Ft. Worth 1971, writ ref'd n.r.e.); *Milliner v. Elmer Fox & Co.*, 529 P.2d 806 (Utah 1974); and *First Nat'l Bank v. Crawford*, 386 S.E.2d 310 (W. Va. 1989).

154. The Supreme Court of Colorado recently applied RESTATEMENT (SECOND) OF TORTS § 552 to attorneys who prepared opinion letters in connection with a securities offering. *Mehaffy, Rider, Windholz & Wilson v. Central Bank*, 892 P.2d 230, 236-37 (Colo. 1995). Other courts have held attorneys liable to third party investors based upon lack of care in preparation of opinion letters upon which they knew investors would rely. See, e.g., *Ackerman v. Schwartz*, 947 F.2d 841, 847 (7th Cir. 1991) (plaintiff investors allowed to reach tax lawyer who rendered opinion because "Indiana does not apply a privity rule in fraud cases"); *Horizon Fin. v. Hansen*, 791 F. Supp. 1561 (N.D. Ga. 1992) (attorney's opinion letter could support liability to third party under either Georgia or Pennsylvania law). See generally Lawson & Mattison, *supra* note 152, at 1341 ("the line between the third party liability of attorneys and accountants may be much narrower than a simple nose count of jurisdictions presently suggests").

investment bankers who render fairness opinions, celebrity spokespersons who aid in the sale of recreational real estate or investment schemes, and many other professionals.

With regard to liability to third parties for negligent misrepresentation, after *Central Bank* and the Private Securities Litigation Reform Act of 1995, the conclusion I reached in 1992 after examining the maze of state securities law seems more apropos than ever:

The future may then come full circle. Plaintiffs in states in which the courts take a restrictive attitude (toward the scope of state securities law) will rely increasingly upon claims of simple negligence against collateral participants in securities transactions. Those plaintiffs will attempt to slip the bounds of a common law privity requirement by analogy to the accountant cases. In a good many jurisdictions, courts have held accountants liable to third parties with whom they have not dealt if the third party was foreseeable, or at least a member of a foreseeable class. . . . A great deal of uncertainty, and some seemingly intractable questions, seem to persist in the area of state securities laws. The way out of the maze may be old, true and tried common law cases and methods.¹⁵⁵

III. CONCLUSION

Nothing that Congress or the federal courts have done changes one central element in the equation. That element is that whenever and wherever other people's money is sought, the presence of rogues is likely, if not on center stage then in the shadows. The methods by which those rogues may be held accountable to defrauded investors have been vastly reduced by somewhat naive legislators and judges who seem to have little inkling of the realities of the securities business.

Be that as it may, the practical conclusion one reaches is that, except in an action against a solvent issuer, or a collateral participant who has actually participated in making a fraudulent statement to investors, by named plaintiffs, a strong bias now exists against filing a securities lawsuit in our federal courts. The avenue plaintiffs' attorneys contemplating other types of actions may find necessary to take include state securities law and common law actions, filed in state court.

Thus, it is that the world has now turned upside down. The traditional destination for large complex pieces of civil litigation, our capable and at times majestic federal courts, will now receive the smaller cases. After sixty some years under the federal securities laws, the safer haven for many complex civil cases or cases involving egregious types of the very kind those statutes were intended to prevent or remedy, has become the state court of general jurisdiction.

155. Branson, *Collateral Participant Liability Under State Securities Laws*, *supra* note 1, at 1066-67.

